Internal Revenue Service
memorandum

CC:TL-N-10077-91
Br2:JMSchwartzman

date: SEP 11 1991

to: District Counsel, Seattle CC:SEA
Attn: Lisa Oshiro

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]--Notice of Deficiency

This memorandum responds to your request for formal assistance concerning the proper method for including in [redacted] income the $[redacted] of payments by [redacted] ([redacted]) to [redacted], consistent with the [redacted]. As you know, we are asserting a deficiency against [redacted] solely as a protective matter, pending the appeal of [redacted], which we believe was incorrectly decided.

As you noted, the revenue agent proposed to issue the notice of deficiency to [redacted] for the face amount of the obligation to [redacted], $[redacted]. You believe that it would be more accurate to issue the notice of deficiency for the present value of the $[redacted] payments to be made over time.

We believe the correct method of including the $[redacted] in [redacted] income is as follows. In a deferred payment sale, a cash-basis seller ([redacted] is a deemed seller according to the district court) treats the fair market value of the purchaser's obligation as an amount realized in the year of the sale only if the obligation is represented by a negotiable instrument and, hence, constitutes property. Treas. Reg. § 1.453-6(a)(1). Where no such negotiable instrument is received, the obligation is treated as an unsecured contractual obligation to pay the balance of the purchase price, like an account receivable. As such, the cash-basis seller should include each cash payment as an amount realized only when received. Estate of Hurlburt v. Commissioner, 25 T.C. 1286 (1956). See Colson, Federal Taxation of Sales, Exchanges and Other Transfers (1971) pp. 190-191.

[redacted]'s $[redacted] obligation was satisfied by 1) forgiving [redacted] $[redacted] debt to it (as of [redacted]), 2) two $[redacted] cash payments to [redacted], one to be paid between [redacted] and [redacted] and the second to be paid between [redacted] and [redacted] and 3) monthly payments to [redacted] of $[redacted] each, plus interest, commencing [redacted] and continuing until the balance is paid off.

We believe that [redacted]'s obligation to pay [redacted] does not constitute a negotiable instrument. This is so because the purchaser did not execute any notes, bonds or other evidences of indebtedness other than the "Agreement as to Corporate Stock." See Johnston v. Commissioner, 14 T.C. 560 (1950) ("... when the contract merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which could be recognized as the equivalent of cash to some extent, are given and accepted as part of the purchase price ... [it] creates accounts payable ... which [the purchaser and seller] would accrue if they were using an accrual method ... [b]ut ... has no tax significance to either purchaser or seller if he is using a cash system."). See also Estate of Hurlburt, supra. Thus, the fair market value of the obligation is not included in [redacted] income in the year of sale. Rather, payments on the obligation are included in [redacted] income as received.

Accordingly, The $[redacted] note forgiven [redacted] and the first $[redacted] cash payment[1], if made by [redacted], are includible in Mr. Arnes' income for [redacted]. Although the 3-year statute of limitations may have run with respect to [redacted], if the total payments made on this obligation constitute more than [redacted] percent of the gross income indicated on [redacted] income tax return, then a 6-year statute of limitations will apply, based on a substantial omission of income. Section 6501(e). As a result, a notice of deficiency could still be issued to [redacted] for [redacted].

With respect to [redacted] tax year, the $[redacted] payment is includible in his income for that year, as well as the first $[redacted] payment if made during [redacted]. In addition, the $[redacted] monthly payments, plus interest at [redacted] percent, are includible in [redacted] income for the [redacted] months they were paid during [redacted] ([redacted] to [redacted]). For [redacted] and each subsequent year until paid off, all monthly payments, plus interest, are includible in [redacted] income for the tax year in which they are received.

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[1] The contract calls for two $[redacted] payments. The first was to be paid between the date of the contract, [redacted] and January 2, 1988. It should be ascertained when this payment was made for purposes of determining the proper year of inclusion. The second $[redacted] payment was to be made between [redacted] and [redacted]. Thus, [redacted] is the proper year of inclusion for that payment.

Because of some uncertainty regarding whether [redacted]'s obligation should be treated as property for purposes of inclusion in income, we recommend that the notice of deficiency for [redacted] contain the alternative ground that the fair market value of the $[redacted] obligation be included in [redacted] income for that year, i.e., the year the obligation was received. If, under our primary theory, the deficiency amount does not constitute a substantial understatement and, therefore the 6-year statute of limitations does not apply, the notice of deficiency should contain only the theory that the fair market value of the $[redacted] obligation is included in [redacted] income, provided that there is some factual basis for asserting that [redacted]'s $450,000 obligation was a negotiable instrument which would therefore constitute property.

Please note that this memorandum is for COUNSEL USE ONLY.

If you have any questions, please contact Jerry Schwartzman at FTS 566-3407.

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